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The financial markets are ending 2018 on an ugly note causing many to question what 2019 holds. Stock market corrections are common and can be triggered by anything (or nothing at all). Bear Markets are the result of economic contraction (recession) or a Central Bank policy error. The economic data does not support the idea that a recession is imminent but that can change quickly.

Two data points I track for visibility on the economy are the Index of Leading Economic Indicators (LEI) and the NFIB survey on Small Business Optimism. When both economic gauges show strength, as they do now, the likelihood of recession within 6 months is historically nonexistent.

Commentators and analysts are speculating on the cause of the worst December for stocks since 1931. What the volatility may portend is a massive Reversion to the Mean changing the passive-active debate.

According to Morningstar, in 2007 passive investing was 20% of equity investments but has grown to almost 50% today. The combination of lower costs and outperformance has led to an explosion of passive opportunities and Bloomberg reports there are more passive indices that can be traded than there are publicly traded stocks.

Reversion to the mean simply states that prices will move towards their long-term averages. Deviations above or below the average ultimately revert back. The current bull market has rewarded passive investors for a decade but that may soon revert as volatility rises and a recession in 2019 becomes more likely. Correlations are likely to move towards one in the coming year setting the stage for active management or dynamic indexing to outperform.

Growth Scare or Economic Downturn?

As mentioned above, data today suggests a recession is unlikely the first half of 2019 but increasingly likely the latter half of next year as the Fed seems intent on creating the environment for a contraction to occur. Quantitative Easing

(QE) added liquidity to the markets resulting in risk asset appreciation so it only makes sense that Quantitative Tightening (QT) would remove liquidity. The Fed is reducing its balance sheet by \$50 billion per month — that equates to additional 1/4% hike in rates.

Headwinds Blowing

1. **Tight Financial Conditions**
2. **Trade Uncertainty**
3. **Chinese Slowdown**

An inverted yield curve, trade war with China, and recession in Europe will simply compound what appears to be a Fed policy tightening error. The synchronized global growth since 2017 where the U.S., China, and Europe all experienced above trend growth appears to be headed for a synchronized downturn in 2019.

Headwinds Blowing

1. *Tight Financial Conditions*
 - higher yields are negatively impacting housing and Capex
 - QT is draining liquidity needed for risk asset appreciation
 - QE is winding down in Europe as growth wanes
2. *Trade Uncertainty*
 - risk that trade war with China expands to Europe in 2019
 - tariffs serve as form of national sales tax slowing demand
 - hard Brexit creates global trade uncertainty beginning in the UK
3. *Chinese Slowdown*
 - China contributed a disproportionate share of global growth the last 10 years but are contracting
 - PBoC policies to de-risk the banking system are hurting liquidity and growth
 - corporate defaults of non-SOEs hitting an alarming rate

2 Scenarios for 2019

How the headwinds are dealt with from a policy making standpoint will ultimately determine if we witness a growth scare or global recession in 2019 with major impact for the markets. Some of this is already playing out as importers brought forward 2019 demand into late 2018 to beat higher tariffs.

Scenario 1:

- Fed sits on the sidelines in 2019 and pauses QT
- China moves from tightening to stimulus in 2019
- Trade truce is achieved

Scenario 2:

- Fed hikes at least 1 time in first half of 2019 and cont. QT
- Retaliatory tariffs increase and spread to Europe
- China de-values their currency in attempt to spur growth

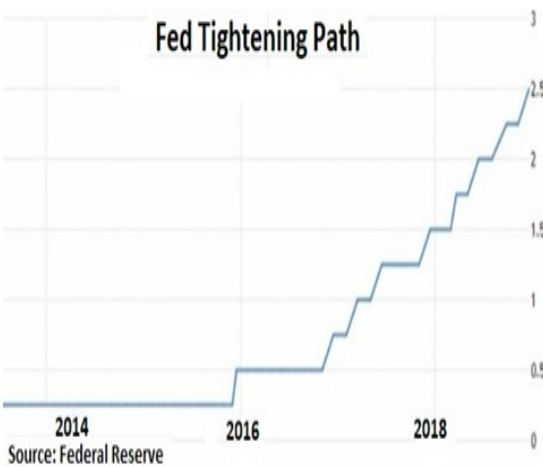
Risk assets would likely recover all losses from late 2018 if scenario 1 were to play out. It would make buying the S&P at only 14X projected 2019 earnings a bold and very profitable move. If scenario 2 or anything resembling that happens next year then a recession is increasingly likely in 2019 and the market drawdown is probably less than half way through.

UNITED STATES: CORPORATE DEBT TO GDP



SOURCE: Haver Analytics, Gluskin Sheff

The Fed Said What?



In what may go down as the low point of Fed Chair Powell's term, his press conference following the December rate hike left investors scratching their collective heads. While claiming to be data-dependent, the Chair nonetheless suggested that their balance sheet normalization, i.e., QT, will resume without deviation in 2019. This makes Powell seem a bit out of touch and turning a deaf ear to what the markets are screaming. How the Fed could simultaneously reduce their forward growth forecast and hike at the same time seems inconsistent with being data-dependent. At issue is what is the true neutral rate for the Fed as Powell sees no need to be accommodative and does not believe current policy is restrictive, something the markets are convinced he is wrong about.

- Bond king Jeff Gundlach of Doubleline suggested Powell and the Fed has lost credibility by ignoring the giant sucking sound of liquidity leaving the markets from QT.
- Models suggest that \$80B of QT equates to a 1/4% rate hike. This would mean that the markets have had to digest 13 rate hikes since the Fed starting hiking in late 2015.
- The Vix index that gauges investor fear spiked to above 30 in late December, going from fear to panic as investors seemed convinced a major policy mistake is being made.

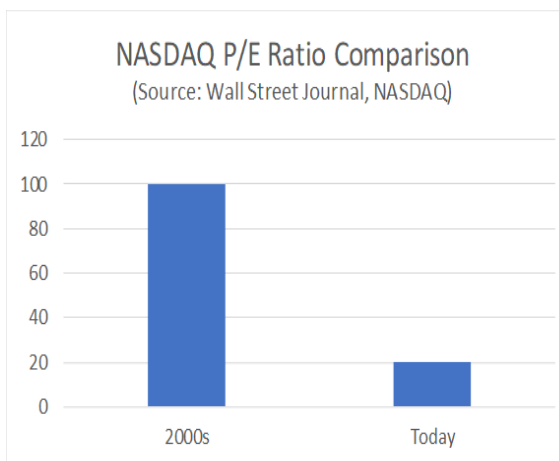
The Buck Stops Here?



Portfolio managers are communicating that the economy and the market may be at an inflection point between stable economic indicators and sentiment signaling a recession months away versus a market that cannot seem to find a floor. A driving force offering insight in to how 2019 may play out is the US dollar. An appreciating dollar punishes US companies with significant revenue derived overseas and companies that export their goods. Much of the appreciation can be attributed to other global currencies devaluing, and the tax bill that was passed encouraged companies to bring business and dollars back to the U.S. Tightening monetary policy coupled with relaxed fiscal policy creates a backdrop for an appreciating dollar because global investors seek out currencies that reflect rising rates versus currencies that are depreciating and reflect low rates.

- The chart to the left shows the value of the US dollar, YTD as of December 24, 2018, reflected through the Invesco ETF, US Dollar Index Bullish Fund (UUP).
- As of 12/18/18, the US Dollar had appreciated 8.03% based on the ETF, UUP (ETF.com).
- In order for the dollar to depreciate in 2019, one would expect monetary tightening to occur in Europe or Japan or the U.S. to reduce their tightening policy.
- President Trump has repeatedly commented on the need for a weaker dollar, yet monetary and fiscal policy action are likely to continue to drive the dollar higher.

Tech Wreck 2.0?

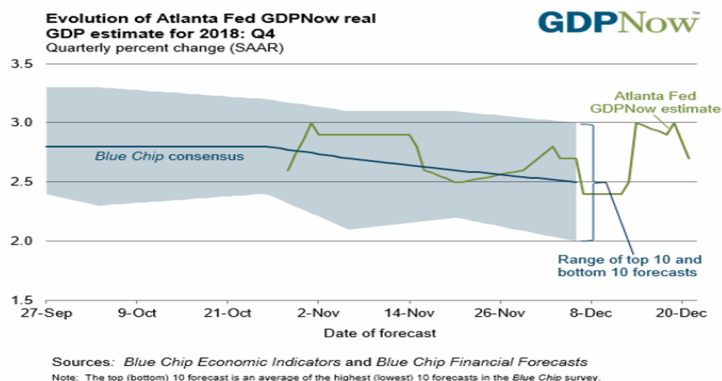


With the recent decline in technology stocks, particularly the so-called FANG names – some investors might be wondering if we are about to go through another “tech wreck” like what we experienced in the early 2000’s. Afterall, some of the most widely followed technology names, such as Amazon, Netflix, Facebook, etc., are more than 30% off of their all-time highs through December. These stocks, collectively, represent well over a trillion dollars of market capitalization in the U.S. equity markets. As such, their performance drives the major indexes, such as the S&P 500, and portfolios that closely track these indexes. However, we don’t consider the recent pullback in the technology sector as a second version of the “tech wreck” of the early 2000s.

- One glaring difference between now and twenty years ago is the quality of the companies that represent the technology sector. Today, these companies have an actual economic footprint (i.e. sales, revenues, cash flows, etc.), unlike the hot IPOs from the late 1990s and early 2000s.
- With an economic footprint, we can analyze and evaluate these companies to determine their actual worth. In other words, these companies aren’t likely to go out of business. *The current pullback we’ve seen is more likely a correction of an overvalued market.*

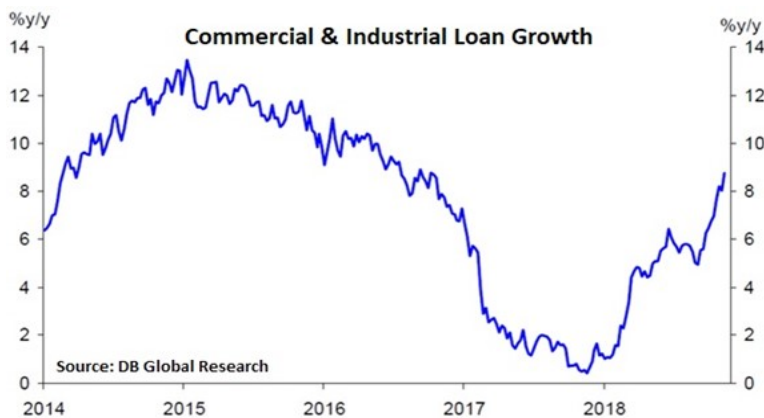
Macro View – GDP in Focus

The growth rate of GDP is a key indicator in determining the health of an economy. The official estimate is backward looking as a result of a delay in reporting results. The Atlanta Fed's GDPNow offers a "nowcast" by estimating GDP growth as a running estimate of real GDP growth using data from the current quarter. The GDPNow model estimates fourth quarter 2018 GDP at 2.7% as of December 21, 2018 (Atlanta Fed). This result is down from 2.9% as of December 18. The chart below shows Q4 2018 changes in GDP estimate for the Blue Chip consensus, the range of top 10 and bottom 10 forecasts, and the Atlanta Fed's GDPNow estimate. The Blue Chip consensus has been trending down over the course of the quarter, just above 2.5% as of December 8th. The GDPNow estimate has been largely range bound for the quarter, between 2.5% and 3.0%. It should be noted that GDP is in a downtrend.



Fixed Income - Counter-trending?

The recent strength in Commercial & Industrial loan growth suggests the economy is not hurtling toward a slowdown that could cause recession. C&I loan growth is a key data point for what is happening with commercial growth in the economy. The chart shows the dramatic drop in loans in the 2nd half of 2017 even though through economy was surging. The rapid increase in 2018 has happened even though the 2/5 yield curve has inverted — that typically suggests a slowdown in lending. The growth in commercial loans is likely related to the corporate tax cut that took effect in 2018, motivating companies to increase capital expenditures or Capex. As 2018 comes to a close, consumer spending remains strong, making a recession in the first half of 2019 unlikely. Long duration yields remain very attractive even as short-term adjustable rates have risen sharply.



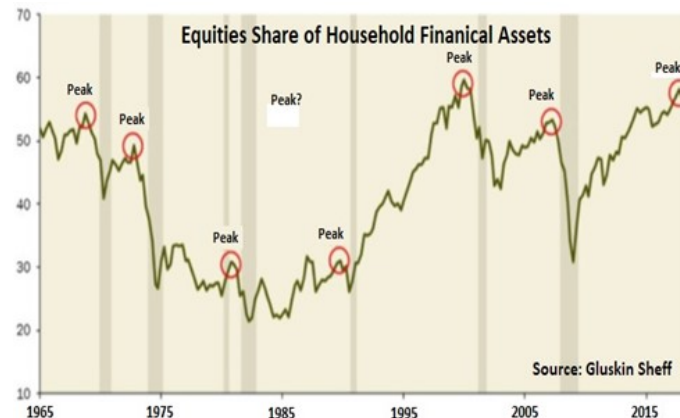
Taking Stock – Emperor Ma

Jack Ma, founder and chairman of Alibaba (BABA), was recently named to the Chinese Communist Party. Ma's entry into the party is an expression of his buy in to party policy, likely to further favor in galvanizing Alibaba as a global juggernaut. The Chinese government is then able to leverage that juggernaut to galvanize their policies imposed on the people. BABA is valued at more than \$400bb (Bloomberg), ranking it among the top 10 most valuable companies in the world. Ma has been vocal in supporting Xi in encouraging Chinese entrepreneurs thriving within Xi's economy. The Xi/Ma team may be difficult to beat. For example, Jack Ma declared that 11/11 is "Singles Day" where citizens should buy themselves a gift (using Alibaba). The result was \$30.8bb in sales, a record, in a single day. There are clear risks associated with investing in China and emerging markets. As of December 21, 2018, BABA was down over 27% for the year.



Technical - Peak Equities

It is well documented that bull markets are driven by multiple factors but the most important historically are excess liquidity and demand. Technical strength of stocks depends on a surplus of buyers compared to sellers. In late 2018 the amount that households held in stocks as a percentage of overall financial assets peaked in a fashion similar to prior market tops. The dramatic drop in stocks in December is likely to create an even greater pullback in the share of equities held by households. As is typical with most technical charts, when an inflection point is hit the result is often a strong pullback as can be seen in prior periods on the chart. After the latest Fed hike taking Fed Funds to 2.5%, short term savings accounts are now yielding 3% or more, making cash a competitor for the first time in over a decade.



Risk Management vs. Risk Avoidance

Clint Pekrul, CFA

Our approach to portfolio management is to quantify and manage risk in the financial markets and make portfolio decisions (i.e., buys and sells) based on the data we observe. Namely, we absorb information in the form of prices for the investments we hold. We evaluate how uncertain future returns might be, and how correlated returns might be across various asset classes (e.g. stocks and bonds). Under certain circumstances, the market environment might change in such a way that we rebalance, or trade, client portfolios.

Considering the recent market volatility, which has seen major equity indexes decline roughly 20% from their all-time highs, we wanted to reiterate how our methodology of risk management differs from the approach many investors might consider when markets become choppy: *risk avoidance*. Simply put, risk avoidance is to decouple your portfolio from the market risk by moving your assets into cash. In our experience, this market timing approach generally doesn't yield attractive long-term results.

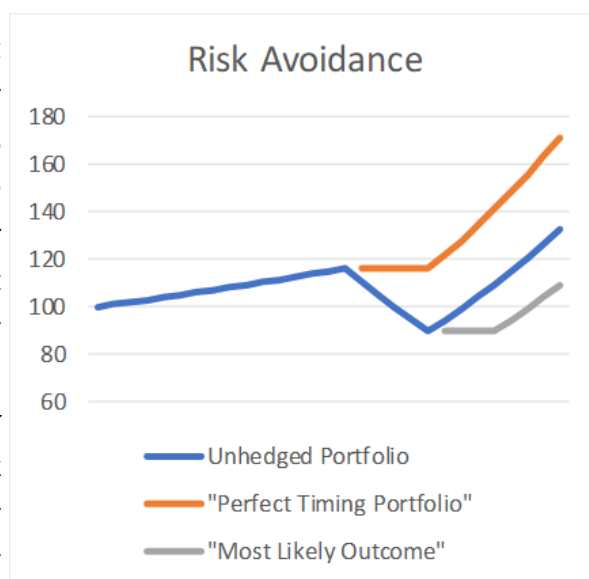
Risk Management vs. Risk Avoidance

To be clear, when we reference risk avoidance, we are describing a process of selling all, or most, of your risky assets and moving into cash when market returns become highly uncertain (such as the environment today). Investors panic because prior gains can be quickly reversed. Rather than risk further loss, investors chose to sit on the sidelines until things "cool down." In our view, risk avoidance can be a risky strategy long-term. The chart below helps explain way.

To illustrate our point, we plotted the value of a hypothetical risky portfolio in blue (think S&P 500). The orange line depicts the value of a perfectly hedged

portfolio that went to cash at the top (hence the flat line) and bought back in at the bottom and is worth far more at the end of the day. The grey line represents a portfolio that absorbed the loss, then hedged with cash, and then waited until the markets rose and bought back in. It's worth far *less* at the end of the day.

The risk of risk avoidance is that the grey line in the chart is generally, based on our experience, the *most likely outcome*. Nobody can consistently time the top (when to go to cash) and time the bottom (when to jump back in).



Source: Peak Capital Management, YCharts

When you remove all the volatility from your portfolio (i.e. you go to cash) you're explicitly saying with certainty that markets are moving lower. Experience tells us that markets can reverse course quickly, and the only way to recover from a loss is to have some skin in the game. After all, cash will not provide any degree of upside potential.

We prefer to manage risk by holding a portfolio of complementary assets that don't generally exhibit highly correlated returns. This does not prevent losses, but our view is that dialing up and down portfolio exposures based on what we observe, rather than make the binary "on" or "off" decision of risk avoidance, is a better form of portfolio management.

As an example, our current equity portfolios maintain a majority exposure to stocks (hence, we tend to move up and down in tandem with the overall market), but we also maintain an allocation to U.S. Treasuries (a negatively correlated asset) and a modest short hedge to the S&P 500. The allocation is based on current market volatility and correlations, but as these dynamics change, so will our asset allocation. We can potentially protect, to a degree, against further declines, but can also participate, to a degree, on any rebounds to the upside.

Q: Will the end of Draghi's term at the ECB impact the markets?



Given the importance of the EU economy to global growth, I do expect the person who replaces Draghi to be very important to maintain stability in the global markets. The EU combined economy, second only to the U.S. economy in terms of size, is extremely diverse and represents the vastly different economies of the north (Germany, France and Ireland) with those in the south (Italy, Spain and Portugal).

There is always a desire to balance the policy making roles in the ECB. The leading candidate to replace Draghi is Sharon Donnery, the Deputy Governor of the Irish Central Bank. Donnery is viewed as a strong bank regulator and is favored among the northern nations. Andrea Enria, chair of the European Banking Authority, is another leaving candidate and is the favored replacement for most in the south. The decision could also be influenced by the desire for more gender equality tilting the nod towards Donnery.

The transition will be particularly important given that the ECB has announced the end of QE with a focus on an asset purchase strategy to remain accommodative. If the northern economies continue to weaken and slip into recession, the ECB will need a leader strong enough to sell further easing or stimulus. The battle between what the northern nations need for monetary policy and what facilitates the southern nations will be the battle that ultimately brings about the Euro's demise.



I'm not sure the end of Draghi's term, in and of itself, will impact the markets. The eurozone has numerous challenges ahead in 2019, including a potentially no-deal Brexit and an overall slowdown in economic activity in the bloc. Draghi has alluded to the implications of a messy Brexit. The Bank of England has put markets on notice that should Brexit not go smoothly, the U.K.'s economy could contract by 8% and the pound could devalue by 25% or more. The ECB kept its policy interest rates unchanged after its latest meeting, as expected. But future growth prospects in the eurozone are weak and trending to the downside. Growth in the region is expected to be around 1.5%. In addition, we can throw Italy into the mix. The ECB will no longer absorb the majority of Italy's bond issuance (the central bank's bond purchase program is ending), which means Italy must find private buyers to fund its debt issuance. Should this not happen, then there could be larger contagion issues. So, in the grand scheme of things, the market isn't going to necessarily miss Draghi per se. There are much larger unknowns at play that the market must price in for 2019.

Q: What will *really* surprise the markets in 2019?



It is always fun to respond in a tongue-in-cheek manner when looking at the coming year so here is my list of what would be beyond a surprise in the coming year. First, Jerome Powell realizes that he made tragic mistakes as the Fed Chair and decides to resign amidst a deep recession in 2019. Trump, feeling vindicated for opposing the last rate hike decides to nominate Mark Cuban as the new Fed Chief. Cuban accepts the appointment and is confirmed by 98 senators as Democrats support the nomination believing it keeps him out of the 2020 race. Only Senator Rubio, who assumed Cuban was from Havana and Senator Warren, who disputed Cuban's claim of minority status, voted in opposition of the nomination.

Tom Brady suddenly retires from the NFL after losing in the first round of the playoffs to the Cleveland Browns (who made the playoffs when both Houston and Baltimore were disqualified for using illegal aliens as players). Brady immediately announces his intentions to run for the U.S. Senate from Massachusetts against Edward Markey in 2020. Brady is endorsed by Colin Kaepernick but opposed by sporting goods company Wilson who said he was disqualified on the basis of Deflategate. Brady is the overwhelming favorite in the race and is already slated to win the 2024 nomination with Giselle competing to be the most attractive FLOTUS in history.



There are several issues that would really, really, really surprise the markets in 2019. Imagine if Warren Buffet, arguably one of the greatest investors of all time, suddenly decided to launch his own crypto currency fund – BuffetCoin. I think investors would have to reevaluate their view of Warren as the ultimate value investor. In a sudden act of altruism, Facebook CEO Mark Zuckerberg might volunteer to appear before Congress to provide a comprehensive overhaul of social media platforms, including new regulatory guidelines for privacy protection. Frustrated by a lack of broad GOP support for a border wall, president Trump, in an act of incredible spite, could fire Fed Chairman Powell and appoint Senator Bernie Sanders to head the central bank, and then could task Senator Elizabeth Warren to chair a new committee to further regulate investment banks. And while it might not surprise investors all that much, it would certainly surprise the sports world if the Colorado Rockies won the pennant and the Cleveland Browns made it to the Super Bowl.

All weights as of December 27, 2018

Income	
Mortgage Backed Bond	39.00%
Investment Grade Credit	17.00%
High Yield Bonds	14.00%
Preferred Stock	12.00%
US Dividend	5.00%
US REITs	6.00%
Short (Inverse) Treasury Bond	5.00%

Balanced Income	
US Dividend Equities	12.00%
International Dividend Equities	11.00%
US REITs	12.00%
High Yield Bonds	30.00%
Long Term Treasuries	28.00%
Short (Inverse) US Equity	5.00%

US Growth	
Low Volatility Factor	20.00%
High Quality Factor	10.06%
Small Cap Factor	9.85%
Value Factor	21.00%
Momentum Factor	8.44%
Long Term Treasuries	23.00%
Short (Inverse) U.S. Equity	8.00%

Global Growth	
Low Volatility Factor	13.00%
High Quality Factor	8.00%
Small Cap Factor	6.00%
Value Factor	11.00%
Momentum Factor	5.00%
Developed Market Equity	17.00%
Emerging Market Equity	10.00%
Long Term Treasuries	25.00%
Short (Inverse) U.S. Equity	5.00%

Weights are approximations only and subject to change.

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